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SUBJECT: IMF AND GOT CLOSE TO AGREEMENT ON FIFTH REVIEW

REF: ANKARA 4316

11. (SBU) Summary: IMF and Turkish officials are close to an agreement that would pave the way for the Fifth Review to proceed, and hope to announce agreement by Friday, July 18. Discussions this week have focused on closing the estimated \$1.8 billion fiscal gap. Although there has been some talk here that the Fund staff has been "lenient" on the fiscal side, ResRep and Mission Chief insist Turks have agreed to ambitious and credible measures to close the gap. On the structural side, Parliament passed the final piece of social security legislation July 17. We understand other structural conditions will be pushed into the Sixth Review. Mission Chief has urged Turks to travel to Washington as soon as they complete the LOI to finalize and sign the financial agreement on U.S. assistance. Meanwhile, markets have strengthened this week due to investor perceptions of progress on the review and on U.S.-Turkish relations, with an added boost from the Central Bank's July 16 interest rate cut. End Summary.

12. (SBU) IMF and GOT officials told us late July 16 that they have made substantial progress this week, and hope to announce agreement on an LOI by Friday, July 18. IMF ResRep said the discussions have focused on fiscal issues, specifically how to fill the fiscal gap -- the expected shortfall in this year's primary surplus target of 6.5 percent of GNP. According to both IMF and GOT officials, the gap -- identified by the last mission at approximately TL 1 quadrillion -- has grown, due in part to the government's recent wage hike for civil servants, and now is projected at TL 2.5 quadrillion (approximately \$1.8 billion).

13. (SBU) Treasury Acting Director General Melih Nemli and Finance Deputy DG for the Budget Ahmet Kisik outlined to us on July 16-17 the measures the GOT has agreed to take fill the gap: (a) continuing until year-end a freeze on TL 1.2 quadrillion in spending (of the TL 4 quadrillion in spending that was temporarily frozen in the spring); increasing the Special Transaction Tax and Educational Levy (TL 210 trillion); sale of Treasury's hazelnut stock (TL 70 trillion); savings on the foreign currency element of certain investment projects resulting from the lira's strength (TL 200 trillion); and shifting "special revenues" normally earmarked for individual agencies to the general budget (TL 580 trillion). Kisik explained that the "special revenues" were a remnant of Turkey's various off-budget funds, most of which have been closed. Beginning next year, nearly all of these revenues will go to the general budget. This year was a transition period, but the government has decided to shift the revenues to the general budget to help close the fiscal gap. He added that any remaining gap should be filled by higher-than anticipated petroleum taxes.

14. (SBU) A few observers, including an Istanbul economist and a mid-level GOT economic official, have suggested to us that the Fund team was "lenient" in accepting the GOT's proposed fiscal measures. IMF ResRep and Mission Chief insisted, however, that they were being tough and that the Turkish measures were credible and serious. ResRep said Mission Chief had given a strong opening statement in the initial Fund-GOT meeting that had caused State Minister Babacan's face to fall. Mission Chief said the Turkish team seemed to have a different -- much more serious -- attitude this time around, and had agreed to an "impressive" series of measures, something he attributed in part to the efforts of Treasury U/S Canakci. He added that he had warned Ministers Babacan and Unakitan that the GOT's populist "noise" was undermining market confidence, and that they needed to step up their performance (and improve their rhetoric) to begin to regain that confidence.

15. (SBU) The often-skeptical Ahmet Kisik agreed that the fiscal measures were credible. While complaining that the GOT could and should have completed this review two months ago, potentially saving TL 2-3 quadrillion (through lower interest rates), he argued that the government has become more serious. He suggested that Finance Minister Unakitan's recent roadshow to the U.S. -- during which U.S. investors had stressed the importance of completing the Fifth Review -- had a major impact on GOT thinking. He added that the new fiscal measures would not cause much pain to the public and could be implemented through administrative action. In fact, he already has sent a letter to all the line ministries advising them that the Ministry has frozen TL 1.2 quadrillion in spending, and the government announced the increase in the Special Transaction Tax and Educational Levy in the July 17 official gazette.

16. (SBU) IMF ResRep said Fund staff had agreed to push some structural measures into the next review, though it would turn at least a few of them into prior actions to ensure their completion. He said the one remaining structural prior action for the Fifth Review, passage of the last of three laws strengthening and reorganizing the government's social security institutions, should be completed shortly -- in fact, press reports indicate Parliament passed it on the morning of July 17. (Note: Embassy will report more fully on the structural side once LOI is completed, when Fund staff and GOT officials have more time to provide details. End note)

17. (SBU) Turkish markets, meanwhile, have rallied this week, with the lira strengthening to 1.381 million/dollar, bond yields on the benchmark t-bill falling to 47.09, and the stock exchange rising to 10,758 (as of the close of morning trade July 17). Analysts attribute the rally to investor perceptions that the GOT was making progress on completing the Fifth Review and on addressing the flap with the U.S. over the July 4 detention of Turkish soldiers in Northern Iraq. In addition, the Central Bank's July 16 decision to cut overnight interest rates 3 percentage points created room for t-bill yields to fall, per several investors. Analysts were surprised by the timing of the announcement -- they had expected it after the GOT and IMF had agreed on the LOI -- but generally agreed it was justified by recent indications that inflation is declining.

18. (SBU) IMF Mission Chief told us July 16 that he had urged GOT officials to travel to Washington as soon as possible after completion of the LOI to finalize and sign the financial agreement related to the U.S. assistance package. He said an early signing of the agreement, coupled with completion of the IMF review, would boost markets substantially. He was not sure if GOT officials would heed his advice, as they seemed concerned about some of the language in the draft agreement (he did not provide further details).  
PEARSON